B. Jeannie Fry
Director-Federal Regulatory

SBC Telecommunications, Inc.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
Phone 202 326-8894
Fax 202 408-4806

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July 22, 1999

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

WRITTEN EX PARTE

Mrs. Magalie R. Salas
Secretary
Federal communication Commission
Room TW-A325, The Portals
445 Twelfth Street
Washington, D.C. 20554

Re: CC Docket No. 98-137, In the matter of 1998 Biennial Review—Review of Depreciation Requirements for Incumbent Local Exchange Carriers

ASD Docket No. 98-91, USTA Petition for Forbearance from Depreciation Regulation

CC Docket No. 98-177, In the Matter of 1998 Biennial Regulatory Review—Petition for Section 11 Biennial Review filed by SBC Communications Inc., Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell

ASD Docket No. 98-97, In the Matter of United States Telephone Association Petition for Rulemaking-1998 Biennial Regulatory Review

Dear Ms. Salas:

In accordance with the Commission's rules, the following information is provided by SBC Communications Inc. (SBC) to the Commission pursuant to the requests for additional information from Commission Staff economists in attendance of at our May 18, 1999 meeting.[1] The information informally requested by Staff is detailed in the attachments and briefly outlined below.

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[1] See May 19, 1999 Ex Parte filed with the FCC on behalf of SBC Communications Inc. in the proceedings listed above.

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- Attachment 1 represents an update to an exhibit provided at the meeting. Column 3 has been added to reflect the lives employed by SBC for external financial reporting (i.e., GAAP). As can be seen, these GAAP lives are shorter than those prescribed by the FCC ranges but slightly longer than those used by some of the other telecommunications providers listed.

- Attachment 2 provides a comparison of (1) FCC prescribed lives for certain plant categories for SWBT, (2) lives for the same plant categories predicated on forward-looking analysis by Technology Futures Inc. (TFI), and (3) the respective financial reporting (i.e., GAAP) lives for SWBT. As discussed in our May 18 meeting with the Commission Staff, external sources, such as studies and publications from TFI, are publicly available to act as an independent benchmark. This benchmark can confirm the reasonableness of the GAAP depreciable lives for use in Part 32 reporting and for use in UNE cost studies or Universal Service cost reporting.

- Attachment 3 is a portion of the filed testimony by Dr. Robert Harris (Law & Economics Consulting Group or "LECG") and this testimony is responsive to questions in the meeting concerning capital recovery policy during transition periods from monopoly to competition. The following sections are of special note:

    - Pages 7-9 describe FERC's decision in 1996 setting policy allowing electric utilities the opportunity to recover past embedded investment simultaneous with the enactment of open access policy.
    - Pages 19-25 describe FERC's decision in 1992 allowing natural gas companies recovery of embedded investment during a transition to a competitive market.
    - Pages 26-31 explain the actions taken by the FCC in 1989 – 1990 which allowed AT&T to begin using accelerated economic lives providing an additional approximate $1 billion per year in capital recovery to address reserve deficiency issues.

As discussed in our May 18, 1999 meeting, SBC urges the Commission to find that it is in the public interest to allow Local Exchange Carriers to use the same depreciation lives for its regulatory reporting purposes as the carrier uses for its external financial reporting. Financial reporting for Part 32 and interstate jurisdictional reporting would be more representative if carriers were allowed to employ lives based upon the concepts supported by GAAP. These principles mandate the determination of lives based upon current information and the most representative view of the expected life of assets. As such, these lives are synonymous with the forward looking concepts of UNE and Universal Service costing.

An original and two copies of this letter are being submitted. Acknowledgement and date of receipt of this transmittal are requested. A duplicate transmittal letter is attached for this purpose.

Please include this letter in the record of these proceedings in accordance with Section 1.1206(a)(2) of the Commission's Rules.

If you have any question on this, please do not hesitate to contact Ms. Jeannie Fry at 202-326-8894.

Sincerely,

B. Jeannie Fry

B. Jeannie Fry
Director, Federal Regulatory

Attachments

Cc: Mr. Larry Stickling, Chief of the Common Carrier Bureau
Mr. Ken Moran, Chief, Accounting Safeguards Division
Mr. Tim Peterson, Deputy Chief, Accounting Safeguards Division
Mr. Thom David, Accounting Safeguards Division
Mr. Howard Schelanski, Office of Plans and Policy
Mr. Pat DeGraba, Office of Plans and Policy
Mr. Jay Atkinson, Competitive Pricing Division
Ms. Lisa Zaina, Deputy Bureau Chief, Common Carrier Bureau
Mr. Bill Bailey, Counsel, Common Carrier Bureau,
Mr. Don Stockdale, Common Carrier Bureau
Mr. Bob Loube, Economist, Accounting Policy Division
Mr. Craig Brown, Deputy Chief, Accounting Policy Division

Attachment 1

Comparison of FCC Prescribed Depreciation Ranges for ILECs with Competitors Economic Lives (in years)

Plant Category	FCC Prescribed Range for ILEC(1)	Southwestern Bell Financial Reporting Lives	Pacific Bell Financial Reporting Lives	AT&T (2)	Electric Lightwave (2)	TCG (2)
Digital Switching	**13-18**	**11**	**10**	**9.7**	**10**	**10**
Digital Circuit	**11-13**	**9**	**8**	**7.2**	**10**	**8**
Fiber Optic Cable	**25-30**	**20**	**20**	**20**	**20**	**20**
ATT- Most current lives for <u>all</u> Communications and network plant (From 1998 Annual Report)				**3-15**		

Sources:

(1)FCC Prescribed range for digital switching from: FCC NPRM, July 22, 1998, CC Docket No. 98-137.

--FCC prescribed ranges for all other plant categories from FCC Third Report and Order, May 5, 1995, CC Docket No. 92-296.

(2)Depreciation rates for AT&T, ELI and TCG as of 1995 from: Testimony of Robert Harris On Behalf of U S West Communications Inc. Before the Arizona Corporation Commission, AT&T-U S WEST Interconnection Arbitration, Docket No. U2428-96-417, September 30, 1996, p. 38.

SOUTHWESTERN BELL TELEPHONE COMPANY
COMPARISON OF PRESCRIBED LIVES TO ECONOMIC LIVES

Account:	TX FCC SWBT 1998 Prescribed	MO FCC SWBT 1998 Prescribed	KS FCC SWBT 1998 Prescribed	Wtd. Avg. FCC SWBT Composite	Vanston New Investment	Vanston Embedded Investment	SWBT External Reporting
Digital Electronic Switching	14.5	14.5	14.5	14.8	8	9-12	**11**
Digital Circuit	11	11	11	11	4-8	6-9	**9**
Aerial Cable-Metallic	21	20	20	21.2	10-12	14-20	**18**
Aerial Cable-Non-Metallic	25	25	25	25	20	20	**20**
Underground Cable-Metallic	25	25	25	25	10-12	14-20	**15**
Underground Cable-Non-Metallic	25	25	25	25	20	20	**20**
Buried Cable-Metallic	22	20	20	21.1	10-12	14-20	**18**
Buried Cable-Non-Metallic	25	25	25	25	20	20	**20**

Vanston lives for new and embedded investment are recommended projection lives per Transforming the Local Exchange Network Analyses and Forecasts of Technology Change, Second Edition, Lawrence K. Vanston, Ray L. Hodges & Adrian J. Poitras, 1997, Technology Futures, Inc., page 33, Exhibit 1.16. Vanston lives for new investment represent the projection lives for newly-placed equipment. Vanston lives for embedded investment represent the projection lives for existing investment.

The FCC SWBT 1998 prescribed lives represent projection lives determined from the 1998 FCC Three-Way Meeting.

The FCC composite prescribed life is a weighted average composite life based on surviving plant by state for SWBT's five states. This composite life is comprised of 1998 prescribed lives for Kansas, Missouri and Texas determined from the 1998 FCC Three -Way Meeting and 1997 prescribed lives for Arkansas and Oklahoma determined from the 1997 Streamline Filing/Annual Update.

Attachment 3

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

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In the Matter of the Request of U S WEST Communications Inc. for an Increase in its Rates and Charges	)))	DOCKET NO.: 97-049-08

DIRECT TESTIMONY OF ROBERT G. HARRIS
U S WEST COMMUNICATIONS, INC.

April 8, 1997

D. RECOVERY OF U S WEST'S ACTUAL COSTS

1. POLICIES TOWARD RECOVERY OF EMBEDDED COSTS IN THE TRANSITION FROM MONOPOLY TO COMPETITION

Q. DO YOU AGREE WITH THE FCC FINDING THAT PRICES SHOULD NOT INCLUDE ANY EMBEDDED COSTS?[1]

A. I do not. Under the "regulatory contract" LECs must be given an opportunity to earn a reasonable return on their investments and all of the costs they have incurred. During a transition period, these costs include a recovery of the embedded costs incurred to meet regulatory service obligations. Barring business assessment miscalculations, proper depreciation methodologies should assure that net book values do not exceed replacement costs. However, U S WEST's embedded costs in Utah include a depreciation reserve deficiency which was accrued because depreciation rates have been set at uneconomic levels by state and federal regulators who have consistently required that U S WEST use longer asset lives than it would have chosen for itself. These prescribed depreciation lives have resulted in accumulated "uneconomic" costs and potentially stranded investment.

Q. WHAT IS THE REGULATORY CONTRACT?

A. Historically, U S WEST has functioned under an implicit regulatory contract with the states in which it operates. Under the terms of that contract, U S WEST has been responsible for fulfilling three obligations: serving as "carrier-of-last-

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[1] FCC Order, paragraph 705.

resort," providing service on a "ready-to-serve" basis, and selling basic telephone service at geographically averaged prices to ensure affordability, whether or not the price of any given service to any given customer covers its cost. In return, regulators maintained U S WEST's monopoly franchise and guaranteed it a reasonable opportunity to earn a fair return on its investments. U S WEST has historically met its service standards and otherwise fulfilled its service obligations by investing hundreds of millions of dollars in the public telephone network of the fourteen states in its region. These investments were made not as the result of "independent business decisions," but in fulfillment of the aforementioned obligations and with the full expectation that regulators would fulfill their obligation by providing an opportunity for full recovery.

Q. IS THE REGULATORY COMPACT AND RECOVERY OF PAST INVESTMENTS COSTS UNDER THE CONTRACT WIDELY RECOGNIZED AND SUPPORTED BY OTHER EXPERTS?

A. Yes, they are. For example, Sidak and Spulber describe the regulatory compact this way:

> The regulated utility submits to various regulatory restrictions including price regulations, quality of service requirements and common carrier regulations. In return, the regulated firm receives an exclusive franchise in its service territory and its investors are allowed an opportunity to earn revenues subject to rate of return constraints.[2]

Noted economist Irwin Stelzer defines it in a similar fashion:

> First, in return for a monopoly franchise, utilities accepted an obligation to serve all comers. Second, in return for agreeing to

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[2] J. Gregory Sidak and Daniel F. Spulber, Deregulatory Takings and the Regulatory Contract, Conference Paper: Economic and Constitutional Perspectives on Takings, American Enterprise Institute, March 7, 1996, p. 38.

> commit capital to the business, utilities were assured a fair opportunity to earn a reasonable return on that capital.[3]

Baumol and Sidak also concur with the definition of regulatory compact:

> Investors committed their capital, and the companies in turn have undertaken the very large investments and contractual commitments to fulfill their various public service obligations and have accepted regulatory limitations on their allowable rates of return in exchange for the promise of a reasonable opportunity to recover their prudently incurred costs.[4]

Baumol and Sidak go further, asserting that failure to permit recovery of past investments would explicitly run afoul of the contract's most basic tenet:

> [It is what] we call the implicit regulatory compact...that enabled regulators to reconcile their earnings ceilings with a rate of return high enough to compete in capital markets. Failure to allow recoupment of stranded costs will clearly violate this implicit regulatory compact.[5]

Moreover, in testimony filed on behalf of the Edison Electric Institute in response to FERC's proposed rules to establish competition in wholesale electric markets, Dr. Baumol and noted economist Dr. Alfred Kahn argue that 1) fairness compels decision makers to include recovery of past investment in the transition to competition, and 2) competition will suffer absent such recovery:

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[3] Irwin M. Stelzer, "The Utilities of the 1990s", *The Wall Street Journal*, January 7, 1987, in Charles F. Phillips, Jr., The Regulation of Public Utilities, Public Utilities Reports, Inc., Arlington, VA, 1988, p. 21.

[4] William J. Baumol and J. Gregory Sidak, Transmission Pricing and Stranded Costs in the Electric Power Industry, American Enterprise Institute, Washington, D.C., 1995, p. 107.

[5] William Baumol and J. Gregory Sidak, "Pay Up or Mark Down", *Public Utilities Fortnightly*, p. 22.

Any regulatory preclusion of incumbent electric companies recovering their stranded or potentially strandable costs can be deleterious to economic efficiency as well as unfair.[6]

Reconciling the recovery of strandable costs with efficient competition is properly regarded as a problem primarily of the transition ...During that transition,...the incorporation of those costs, unique to the incumbent utility companies, in their prices is a major source of distortion of competition, unless some method for their recovery is devised that equalizes those burdens.[7]

The only way to eliminate...inefficiency is to ensure that the charges to all purchasers, whether shifting or remaining with their local utility supplier, make the same proportional contribution to the recovery of those costs: in that event the free choices of buyers will be guided solely by the relative real costs of the rivals. ...[I]t is not anticompetitive to use the price of transmission as a means of recovering [the costs].[8]

Some might argue that stranded cost recovery is unfair or that it would introduce an inefficient bias against the entrants. This position is unfounded. The purpose and effect of the charge would be to make certain that all purchasers continue to bear equally the costs that were incurred by the local utilities in order to serve them.[9]

Finally, Baumol and Kahn point to the negative effects failure to permit cost recovery would have on capital markets, and hence on the vital infrastructure on which society and the economy depend:

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6 EEI Reply Comments before FERC, Docket Nos. RM95-8-000/RM94-7-002, "Economic Efficiency, Competition and Limiting the Exercise of Market Power", William Baumol and Alfred Kahn, p. A-2.

7 EEI Reply Comments before FERC, Docket Nos. RM95-8-000/RM94-7-002, "Economic Efficiency, Competition and Limiting the Exercise of Market Power", William Baumol and Alfred Kahn, p. A-12.

8 EEI Reply Comments before FERC, Docket Nos. RM95-8-000/RM94-7-002, "Economic Efficiency, Competition and Limiting the Exercise of Market Power", William Baumol and Alfred Kahn, p. A-2, A-13.

9 EEI Reply Comments before FERC, Docket Nos. RM95-8-000/RM94-7-002, "Economic Efficiency, Competition and Limiting the Exercise of Market Power", William Baumol and Alfred Kahn, p. A-2, A-13.

> [There are]...hazards of changing the rules of the game under regulation: a decision by regulators no longer to allow recovery by investor-owned utilities of historically incurred costs to which they had reason to believe they were entitled may well impede efficiency by reducing the willingness of investors henceforward to supply to the industry the funds that efficiency would require be devoted to modernization, maintenance or expansion of plant and equipment.[10]

Q. CAN YOU ELABORATE ON HOW A FAILURE TO ALLOW A RECOVERY OF EMBEDDED COSTS DURING THE TRANSITION TO COMPETITION WOULD BE A VIOLATION OF THE REGULATORY CONTRACT?

A. Yes. As part of the regulatory contract, U S WEST provides ubiquitous, affordable local telephone service to any customer who requests it in its service territory. In exchange U S WEST must be permitted a reasonable opportunity to recover its costs. Because U S WEST was prevented from recovering depreciation expenses in the past, it must be allowed to recover these costs in the near term during the transition to competition. Otherwise, once competition accelerates, U S WEST will not have had a reasonable opportunity to recover its costs. Such a violation could have deleterious long-term effects on the amount of investment by U S WEST and other companies in the state of Utah due to the political uncertainty it engenders. Companies are reluctant to make sunk investments in political jurisdictions where rules are arbitrarily changed in mid-course leaving them with windfall losses on their investments. In this sense, preventing U S WEST from recovering its depreciation reserve deficiency could have long-term negative repercussions for Utah's consumers and businesses.

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[10] EEI Reply Comments before FERC, Docket Nos. RM95-8-000/RM94-7-002, "Economic Efficiency, Competition and Limiting the Exercise of Market Power", William Baumol and Alfred Kahn, p. A-7.

Q. ARE THE REFORMS PROPOSED BY U S WEST IN THIS PROCEEDING CONSISTENT WITH RESTRUCTURING POLICIES ESTABLISHED AS PART OF THE TRANSITION TO COMPETITION IN OTHER PREVIOUSLY REGULATED INDUSTRIES?

A. Yes, they are. Particularly striking is the consistency with respect to the policies and reforms established by the Federal Energy Regulatory Commission (FERC) and by state legislatures and regulatory commissions to manage the transition to competition in the natural gas and electricity industries. In each of these industries, decision makers ultimately recognized that changes in competition policy require changes in the regulation framework intended to achieve those policy objectives. They also recognized that reform must occur ***simultaneous*** with the transition to the new competitive framework. In the specific case of the transition to competition in the natural gas and electric industries, decision makers established two broad categories of reforms. The first were designed to ensure that the incumbent faced a reasonable opportunity to recover the costs associated with the transition from regulation to competition; the second sought to permit the incumbent to compete fairly in the new environment.

The costs tied to the transition, often referred to as "transition costs," included, among others, 1) past investments made under the traditional regulatory framework but rendered uneconomic, or "stranded," in the new, competitive environment, and 2) the costs incurred by the incumbent in implementing the competitive regime.[11]

[11] See FERC Order 636, Docket Nos. RM91-11-000 and RM87-34-065 and CPUC I. 86-06-005, D. 93-05-066 and I. 86-06-005 for natural gas. See FERC Order 888, Docket Nos. RM95-8-000 and RM94-7-001 and CPUC I. 94-04-032 for electricity.

Q. AS PART OF THE TRANSITION TO COMPETITION IN THOSE INDUSTRIES, HAVE FEDERAL AND STATE REGULATORS SPECIFICALLY ALLOWED FOR THE RECOVERY OF PAST INVESTMENTS, CONSISTENT WITH THE REGULATORY COMPACT?

A. Yes, they have. And in each case, the regulatory compact provided the basis for the decision to allow full recovery of past investment in those industries.

Q. PLEASE EXPLAIN THE WAYS IN WHICH DECISION MAKERS IN THESE OTHER INDUSTRIES PERMITTED THE INCUMBENT UTILITY TO RECOVER ITS PAST INVESTMENT COSTS.

A. Looking first to the electric industry, less than three months after Congress passed the Telecommunications Act of 1996, the Federal Energy Regulatory Commission (FERC) issued final rules to implement competition policies included in the National Energy Policy Act of 1992 (EPAct).[12] In EPAct, Congress established a national policy of open, nondiscriminatory access to the US electric transmission network for the purpose of creating a competitive wholesale market for electricity nationwide. Congress charged FERC with the task of implementing its open access transmission policy.

In its final order, FERC acknowledged explicitly that "...the electric industry's transition to a more competitive market is driven in large part by statutory and regulatory changes beyond the utilities' control." [13] FERC's acknowledgment reflects the fact that the dramatic changes proposed in its final rules were in

[12] FERC Order No. 888, April 24, 1996.

[13] FERC Order No. 888, April 24, 1996, 1996 FERC LEXIS 777 Part 2 at *259, footnote 583.

significant part directly attributable to the explicit shift in national energy policy brought about by Congress through EPAct. FERC's conclusion certainly applies equally, if not more, to the telecommunications industry. The Telecommunications Act of 1996 eliminates ***all*** pre-existing legal barriers to entry into the local exchange.

FERC recognized that the policy-driven transition from regulation to competition would leave the incumbent with assets which–though used and useful under the traditional structure–would be left stranded in a competitive environment:

> ...the transition to a fully competitive bulk power market could cause some utilities to incur stranded costs...[A] utility may have built facilities...with the reasonable expectation that its customers would renew their contracts and would pay their share of long-term investments and other incurred costs. If the customer obtains another power supplier, the utility may have stranded costs. If the utility cannot locate an alternative buyer or somehow mitigate the stranded costs...'the costs must be recovered from either the departing customer or the remaining customers or borne by the utility's shareholders.' Accordingly, the Commission proposed to establish provisions concerning the recovery of wholesale and retail stranded costs...[14]

Having thus acknowledged that this policy shift would likely impair the incumbent's ability to recover past investment costs, FERC determined unambiguously that the transition to competition should not sacrifice the utility's opportunity to recover a return of and on past investment:

> [W]e do not believe that utilities that made large capital expenditures or long-term contractual commitments to buy power years ago should now be held responsible for failing to foresee the actions this Commission would take to alter the use of their transmission systems in response to the fundamental changes that are taking place in the industry...It was not unreasonable for the utility to plan to continue

[14] FERC Order No. 888, April 24, 1996, 1996 FERC LEXIS 777 Part 1 at *55-56.

> serving the needs of its...customers...and for those customers to expect the utility to plan to meet future customer needs. With the new open access, the risk of losing a customer is radically increased.[15]

Indeed, FERC determined that, together with non-discriminatory open access transmission service, "...stranded cost recovery [is] the most critical component of a successful transition to competitive wholesale electricity markets"[16]

For these reasons, FERC set policy governing the recovery of embedded costs *simultaneous with the enactment of its open access policy.* Under that policy, the incumbent would continue to face a reasonable opportunity to recover past investment costs left stranded "as a result of customers leaving the utility"–costs which the utility incurred "...under an entirely different regulatory regime..."[17]

Q. **HAVE STATE PUBLIC UTILITY COMMISSIONS ALSO ESTABLISHED POLICIES TO PERMIT INCUMBENT ELECTRIC UTILITIES TO RECOVER PAST INVESTMENT COSTS AS PART OF THE TRANSITION TO COMPETITION?**

A. Yes, they have. In one of the first initiatives to bring retail competition to the electricity industry, the California Public Utilities Commission, for example, has allowed for full recovery of costs incurred by the incumbent under the traditional regulatory framework. The California Commission did not, however, limit recovery to past capital investment. Recognizing that the incumbent electric utilities' financial obligations under the traditional regulatory framework extended

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[15] FERC Order No. 888, April 24, 1996, 1996 FERC LEXIS 777 Part 2 at *258.

[16] FERC Order No. 888, April 24, 1996, 1996 FERC LEXIS 777 Part 2 at *64.

[17] FERC Order No. 888, April 24, 1996, 1996 FERC LEXIS 777 Part 2 at *257.

beyond infrastructure investment, the Commission included in its recovery mechanism "...deferred operating expenses, deferred taxes, unamortized debt expense, costs associated with issuing or reacquiring debt,...nuclear decommissioning expenses... and employee retraining and early retirement programs."[18]

In providing its reasons for allowing such recovery, the California Commission, like FERC, cited its obligations under the regulatory compact:

> Under the current regulatory structure, we have granted utilities monopoly franchises to provide electricity to the consumers in their service territories, and we have required utilities to provide reliable service on a nondiscriminatory basis to all customers within their territories...In fulfillment of these responsibilities, utilities developed a portfolio of generation assets by investing in power plants and entering into purchase agreements on the understanding...that reasonable costs would be recovered by rates. They also assumed various other responsibilities...and responded to specific regulatory or legislative mandates...[T]hese investments were found prudent at the time they were made and therefore they should be entitled to full recovery.[19]

In addition, the California Commission recognized the important effect that recovery of past investment costs could have on the utility's financial viability and network efficiency and reliability:

> [M]aintaining the financial integrity of the utilities is an important goal of this proceeding...Investors' uncertainty about the recovery of transition costs may harm the utility's ability to raise capital and may result in a higher cost of debt.[20]

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[18] California Public Utilities Decision 95-12-063, December 20, 1995, p. 128.

[19] California Public Utilities Decision 95-12-063, December 20, 1995, p. 113.

[20] California Public Utilities Decision 95-12-063, December 20, 1995, p. 115.

> If the utilities were required to write off the entire amount of above-market levels of investments, they could face a financial disruption that might lead to lower system reliability and inefficient operation.[21]

More recently, the California Legislature passed and the Governor signed comprehensive legislation designed to introduce competition into California's retail electricity markets.[22] Assembly Bill 1890, which in general terms affirmed the competitive course set by the California Commission, established as a matter of state policy allowance for the recovery of past investment:

> It is proper to allow electrical corporations an opportunity to continue to recover, over a reasonable period, those costs and categories of costs for generation-related assets and obligations, including costs associated with any subsequent renegotiation or buyout of the existing generation-related contracts that the commission, prior to December 20, 1995, had authorized for collection in rates and that may not be recoverable in market prices in a competitive generation market, and appropriate additions incurred after December 20, 1995, for capital additions to generating facilities existing as of December 20, 1995, that the commission determines are reasonable and should be recovered, provided that the costs are necessary to maintain those facilities[23]

Moreover, the Legislature set a specific timeline for cost recovery–approximately five years–and called on the California Commission to establish a "non-bypassable Competition Transition Charge" to prevent cost-shifting among market participants and to ensure that market participants are unable to evade contributing their fair share to cost recovery.[24]

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[21] California Public Utilities Decision 95-12-063, December 20, 1995, p. 115.

[22] Amendments to California Assembly Bill No. 1890, p. 21.

[23] California Assembly Bill 1890, June 19, 1996, Chapter 2.3, Article 1 (s).

[24] California Assembly Bill 1890, June 19, 1996, Chapter 2.3, Article 1 (s), p. 21.

Beyond California, the Pennsylvania Legislature very recently approved sweeping legislation to bring retail competition to that state's electric industry. The Pennsylvania legislation, like the California Act, "...reaffirmed the principle of [stranded cost] recovery...so long as such costs were prudently incurred..."[25]

Q. IS A REASONABLE OPPORTUNITY TO RECOVER EMBEDDED COSTS IMPORTANT TO REGULATED UTILITIES' FORWARD-LOOKING FINANCIAL VIABILITY?

A. Yes, it is, if financial analysts' responses to recent regulatory reforms in electricity and telecommunications are any indication. The financial community has reacted favorably to California's approach to competition policy. A September 1996 Dean Witter Reynolds industry report states that the California restructuring bill provides "the time and the mechanisms necessary to facilitate passage to a competitive industry while preserving the financial integrity of the affected utilities."[26] It specifically refers to the legislation's provisions for stranded cost recovery as essential to the positive financial outlook for California utilities:

> In our opinion, the California restructuring bill is clearly favorable for holders of the state's electric utilities... The following provisions included in the California bill contribute to our improved outlook for the utilities in that state: A "reasonable" provision for stranded-cost recovery...[27]

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[25] "Pennsylvania Restructuring Bill Will Favorably Impact Credit Quality of State's Utilities," *PRNewswire*, November 26, 1996.

[26] "Electric Utility Perspectives - Industry Report," Dean Witter Reynolds Industry Report, Investext Report No. 2508956, September 4, 1996, p. 1.

[27] "Electric Utility Perspectives - Industry Report," *Dean Witter Reynolds Industry Report*, Investext Report No. 2508956, September 4, 1996, p. 2.

In response to Pennsylvania's recent deregulatory legislation, Duff & Phelps Credit Rating Co. indicated that it "views the bill's enactment favorably from a credit standpoint as it increases the likelihood of majority stranded asset recovery...and recoverability of regulatory assets...generally approved in currently regulated rates."[28]

By contrast, the financial community has responded considerably less favorably to the FCC's reform initiative. According to Bear, Stearns & Co. analyst William Deatherage, the majority of LECs have seen a 6 to 16 percent decline in stock value since August.[29] Deatherage blames the FCC Order's creation of "competitive and regulatory uncertainty" for the decline, stating that the " FCC rules–including those on unbundling that allow networks to be purchased at deep discounts–creates earnings uncertainty."[30]

Q. IN LIGHT OF THE CALIFORNIA COMMISSION'S TREATMENT OF PAST INVESTMENT FOR ELECTRIC UTILITIES, HAS THE COMMISSION ADDRESSED TREATMENT OF PAST INVESTMENT COSTS OF INCUMBENT PROVIDERS IN THE CONTEXT OF LOCAL EXCHANGE COMPETITION?

A. The California Commission initiated a proceeding focused on such costs in the telecommunications industry but has yet to render a final policy decision on the

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28 "Electric Utility Perspectives - Industry Report," *Dean Witter Reynolds Industry Report*, Investext Report No. 2508956, September 4, 1996, p. 2.

29 "Analyst: Competitive and Regulatory Uncertainty Hurts Investment," *Washington Telecom Newswire*, November 20, 1996.

30 "Analyst: Competitive and Regulatory Uncertainty Hurts Investment," *Washington Telecom Newswire*, November 20, 1996.

matter. The Commission refrained because at the time it initiated its inquiry, and when it rendered its decision, the Commission had not yet finalized its comprehensive program of local exchange competition. On that basis, the California Commission concluded it could not gauge the effect of its program on the incumbents' opportunity to earn until its entire program was in place. For this reason the Commission found the incumbents' showings to be "speculative" since "testimony was submitted before...local exchange competition rules were adopted."[31]

Consequently, the Commission invited the incumbent carriers to re-file, but after January 1, 1997, by which time the Commission would have finalized its comprehensive program. The Commission asked the incumbents to show in their re-filed applications "...whether [the] adopted new regulatory program embodied in the roadmap proceedings combined with the NRF-established depreciation methods will deprive them of the opportunity to earn a fair return..."[32] The Commission's decision also invites the incumbents "...to recommend in their applications recovery mechanisms to mitigate any adverse effects of our regulatory policies" and "...who will be charged for the recovery."[33]

Thus, the inquiry that California began in 1995 into recovery of past investment as part of the transition to local exchange competition continues.

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[31] D. 96-09-089, Opinion on the Franchise Impacts on Pacific Bell and GTE California, Inc. Resulting from the Authorization of Local Exchange Competition," September 20, 1996, p.59.

[32] D. 96-09-089, Opinion on the Franchise Impacts on Pacific Bell and GTE California, Inc. Resulting from the Authorization of Local Exchange Competition," September 20, 1996, Ordering Paragraph No. 7, pp. 72-73.

[33] D. 96-09-089, Opinion on the Franchise Impacts on Pacific Bell and GTE California, Inc. Resulting from the Authorization of Local Exchange Competition," September 20, 1996, Ordering Paragraph No. 7, pp. 72-73.

Q. IN ISSUING THAT DECISION, DID THE CALIFORNIA COMMISSION ACKNOWLEDGE THE TREATMENT OF PAST INVESTMENT COSTS IT AFFORDED ELECTRIC UTILITIES?

A. Yes it did. At the same time, however, the Commission discussed what it viewed as potential differences in ratemaking treatment between incumbent telecommunications and electric firms *in California*. The Commission found that such disparities might justify different treatment for recovery of past investment during the transition to retail competition.

For example, the Commission noted that both GTE California (GTE) and Pacific Bell have been subject to a variant of price-cap regulation under its "New Regulatory Framework," or NRF, since 1990. NRF, the Commission concluded, removed prudency reviews or advance approval for major investments and placed considerably more investment risk with management. By contrast, the Commission pointed out, it had only very recently begun moving California's electric utilities away from traditional cost-of-service regulation.[34]

The California Commission also asserted that copper wire-based facilities between the customer's premises and the feeder remain economic since the incumbent could continue to use those facilities to deliver enhanced services such as ISDN.[35]

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[34] D. 96-09-089, Opinion on the Franchise Impacts on Pacific Bell and GTE California, Inc. Resulting from the Authorization of Local Exchange Competition," September 20, 1996, Ordering Paragraph No. 7, pp. 52-53.

[35] D. 96-09-089, Opinion on the Franchise Impacts on Pacific Bell and GTE California, Inc. Resulting from the Authorization of Local Exchange Competition," September 20, 1996, Ordering Paragraph No. 7, pp. 53-54.

It is important to recognize, however, that having identified what it considers to be differences, the California Commission nonetheless concluded by acknowledging the important and unambiguous similarities between the two industries:

> The fundamental similarity between the electric and telecommunications industries is their transition from monopoly to competitive environments and the role the Commission plays in directing that transition. Aside from the regulatory program differences [between the telecommunications and electric industries] discussed above, the showings Pacific and GTEC made are not entirely inconsistent with the criteria the Commission laid out in its electric restructuring decision. We agree with Pacific that we should account for the effects or our longstanding regulatory policies, past decisions, and the ongoing local competition rules during the transition to full competition.[36]

Q. IN YOUR OPINION DO THE DIFFERENCES CITED BY THE CALIFORNIA COMMISSON PROVIDE A BASIS FOR PROHIBITING U S WEST FROM RECOVERING ITS PAST INVESTMENT COSTS?

A. Absolutely not. The reasons for permitting recovery of past investment in the telecommunications industry are even more compelling than those on which the California Commission correctly based its decision to permit recovery of past investment in the electric industry. As I explain below, the California Commission's assessment of potential differences in ratemaking treatment between the two industries is either misplaced or inapplicable in the case of U S WEST.

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[36] D. 96-09-089, Opinion on the Franchise Impacts on Pacific Bell and GTE California, Inc. Resulting from the Authorization of Local Exchange Competition," September 20, 1996, Ordering Paragraph No. 7, p. 54.

First, as mentioned above, the California Commission's inquiry continues; the Commission has not rendered a final decision on the matter. Indeed, the Commission invited the incumbents to re-file applications showing the past investment costs each is entitled to recover and possible mechanisms for recovery. In addition, and also noted above, the California Commission's decision places as much weight on the similarities as it does on the differences between the two industries. Thus, the Commission has not used potential differences in ratemaking treatment between the electric and telecommunications industries as the basis for removing the incumbent local exchange carrier's opportunity to recover past investment costs.

Second, the California Commission cites as one of the key "differences" the fact that GTE and Pacific Bell have for some time faced a variant of price cap regulation, while California's electric utilities have not. But U S WEST continues to operate under a cost-of-service ratemaking structure in Utah. The key difference to which the California Commission refers, therefore, does not apply to U S WEST. Moreover, the Commission's assessment neglects the fact that the incumbent's strict service obligations effectively negate any price cap induced "discretion" for investments made to meet those obligations. Absent additional reforms, price cap regulation does not place with the incumbent the discretion to forego investments needed to meet ready-to-serve and carrier-of-last resort obligations. Thus, even with price cap regulation, strict service obligations continue to require incumbents to make investments they might not otherwise make in a competitive environment if given full discretion. As long as those obligations remain solely with the incumbent, the incumbent should have the opportunity to recover the costs of fulfilling them.

Third, the lion's share of the investment costs at issue in the electric industry are tied to investments in power plant. At least some of those plants were approved and built when the electric utility had the alternative of entering into power purchase contracts with other utilities and/or independent producers under the Public Utility Regulatory Policies Act of 1978 (PURPA). U S WEST faced no such alternatives, and would have faced severe penalties had it not provided the plant necessary to meet its service obligations discussed above.

Fourth, the California Commission errs when it asserts that Pacific Bell's—or U S WEST's—distribution plant is somehow more fungible than an electric utility's power generating assets. Just the opposite is true. For example, if an entrant constructs a power generating facility and competes away an electric utility's customer, the utility can continue to market the electricity from its own power plants to compete to serve growth within its service territory, or to serve other customers outside its region (recognizing, of course, that competition might force the utility to take a lower price for the power).

But if U S WEST loses a customer to a cable company providing telecommunications services, no comparable opportunity exists to redeploy the facilities stranded by the customer's shift to the cable operator's facilities. Moreover, wireless technologies of the sort recently announced by AT&T compound the threat of stranding faced by incumbent LECs relative to their electric counterparts. For example, according to the *Wall Street Journal*, AT&T's wireless technology, referred to as "Project Angel," is designed specifically as a "replacement for copper wires," providing "at least two phone lines and data transmission speed twice as fast as currently available over Bell lines."[37]

Clearly, the threat of stranded plant to incumbent LECs is equal to, if not substantially greater than, the threats electric utilities currently face. As a result, the economic and equity grounds for ensuring that incumbents have an opportunity to recover past investment is more pronounced in the transition to competition in the telecommunications industry than in the electricity industry.

Q. DID THE TRANSITION TO COMPETITION IN THE NATURAL GAS INDUSTRY INFLUENCE THE DEVELOPMENT OF FEDERAL COMPETITION POLICY IN THE ELECTRIC INDUSTRY?

A. Yes, absolutely. Like their counterparts in the regulated electric industry, regulated natural gas utilities had incurred substantial costs to fulfill their traditional service obligations when federal policy makers introduced competition in the late 1970s. That policy decision seriously jeopardized recovery of those costs, the bulk of which were tied to natural gas supply contracts with price terms that exceeded those available elsewhere in the market.

It was precisely FERC's failure to address the costs of these contracts at the outset of, and simultaneous with, the transition to competition in the natural gas industry that prompted FERC to take a more direct approach to competition policy in the electric industry a decade later:

> We learned from our experience with natural gas that...we cannot ignore these [stranded] costs...The introduction of competitive forces

[37] Keller, John, "AT&T Unveils New Wireless System Linking Home Phones to its Network," *The Wall Street Journal*, February 26, 1997, p. B4.

> in the natural gas supply market...has left many pipelines holding uneconomic take-or-pay contracts with gas producers. When the Commission initially declined to take direct action...the US Court of Appeals...faulted the Commission for failing to do so. The court noted that pipelines were "caught in an unusual transition" as a result of regulatory changes beyond their control...[T]he court's reasoning in the gas context applies to the current move...Once again we are faced with an industry in transition in which there is a possibility that certain utilities will be left with large unrecoverable costs or that those costs will be unfairly shifted to other (remaining) customers.[38]

Q. DID FERC ULTIMATELY PERMIT THE RECOVERY OF PAST INVESTMENT COSTS AS PART OF THE TRANSITION TO COMPETITION IN THE NATURAL GAS INDUSTRY?

A. Yes it did. But the US Court of Appeal's reversal and remand of FERC's initial policy decision, in which the court faulted FERC for its failure to address stranded costs, played a significant role in shaping the final rules governing recovery of past investment.[39]

The court's recognition that regulatory distortions were plaguing FERC's policy-driven efforts to restructure the natural gas industry ring true in today's telecommunications industry:

> [T]he pipelines have been caught in an unusual transition. They entered into the now uneconomic contracts in an era when government officials berated pipeline management for failures of supply and constantly predicted continuing energy price escalations.[40]

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[38] FERC Order No. 888, April 24, 1996, 1996 FERC LEXIS 777 Part 2 at *259-261. FERC's jurisdiction extends to significant aspects of both the natural gas and the electric industries.

[39] "We conclude that FERC's decision...reflects questionable legal premises and fails to meet the requirement of "reasoned decision-making." Accordingly, we reverse and remand for further proceedings." [117]

[40] US Court of Appeals for the District of Columbia Circuit, Docket No. 85-1811, 824 F.2d 981, June 23, 1987, **129.

> At the heart of the industry's immediate problem is the discrepancy between the average cost of gas that pipelines have under contract and the much lower price of gas now available...The price discrepancy represents a sunk loss of billions of dollars...At issue among the parties is who should bear it.[41]

The court was unconvinced by FERC's defense that it did not intend to either create distortions in the marketplace or inflict financial harm in its efforts to restructure the industry and foster competition. The court was still less impressed by FERC's assertion that the regulated pipelines might "compete their way out" of the negative financial impacts which the introduction of competition might impose due to contractual obligations entered into under the traditional regulatory structure:

> ...FERC's intent is not at issue. What is in dispute is the likely consequence of its acts... In sum, FERC's seeming blindness to the possible impact of its Order...on...liability, and its tendency to elevate into affirmative benefits what are at best palliatives, seem impossible to square with the requirement of reasoned decisionmaking.[42]

Instead, the court found merit in arguments that FERC's failure to address the issue of stranded costs would have the effect of leaving with the regulated pipeline only "...the least nimble [customers]...for whom it is most costly to develop [alternatives]," and would result in a "...spiraling effect–as each additional [customer departs] service the gas cost burden will grow, driving still

[41] US Court of Appeals for the District of Columbia Circuit, Docket No. 85-1811, 824 F.2d 981, June 23, 1987, **110.

[42] The court described FERC's position this way: "FERC argues that the [Order's] provisions may not injure the pipelines at all. The Commission considers it more likely that the [Local Distribution Company] will either convert to firm transportation on the same pipeline, or else free up underutilized capacity under uneconomic CDs for use by other customers on the same pipeline. In either case, the pipeline may actually increase throughput and, therefore, gain the net benefits of spreading its fixed costs over greater units of gas service." US Court of Appeals for the District of Columbia Circuit, Docket No. 85-1811, 824 F.2d 981, June 23, 1987, **120.

others off." The court went on to agree that these "least nimble" customers would likely be left "...with the burden of the overpriced gas, thus defeating the purpose of the Order and violating the consumer-protective purposes of the Natural Gas Act."[43] On this basis the court concluded that "...FERC's inaction will permanently distort the structure of the natural gas market: by creating an artificial advantage...it will cause the [incumbent's] merchant role to atrophy, despite...greater efficiency."[44]

Q. DID THE COURT'S ACTIONS HAVE A SIGNIFICANT EFFECT ON FERC'S FINAL RULES GOVERNING THE TRANSITION TO COMPETITION IN, AND RESTRUCTURING OF, THE NATURAL GAS INDUSTRY?

A. Yes, they certainly did. When it issued its final rules, FERC recognized explicitly that the shift in policy toward competition should not remove the incumbent's opportunity to recover investments made prior to that shift:

> ...[T]he commission has crafted a rule that balances the interest of the pipelines and their customers by permitting pipelines to abandon firm sales obligations where customers elect to reduce or terminate purchase, and to recover 100 percent of any gas supply costs...incurred as a result of their sales customers' elections.[45] To recover those costs, a pipeline will be permitted to use either a negotiated exit fee, or a reservation fee surcharge...[46] Knowing that the pipelines will be entitled to 100 percent recovery of the costs of realigning their gas supply contracts, [customers] must exercise

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[43] US Court of Appeals for the District of Columbia Circuit, Docket No. 85-1811, 824 F.2d 981, June 23, 1987, **115.

[44] US Court of Appeals for the District of Columbia Circuit, Docket No. 85-1811, 824 F.2d 981, June 23, 1987, **116.

[45] FERC Order No. 636, April 16, 1992 LEXIS 57FR13267 at *94-95.

[46] FERC Order No. 636, April 16, 1992 LEXIS 57FR13267 at *96.

> considerable prudence in deciding whether to exercise their rights...to reduce or terminate their purchase obligations.[47]
>
> The Commission is authorizing 100 percent recovery of prudently incurred gas supply...costs incurred as a result of the full implementation of the rule because of the further significant industry-wide restructuring imposed by the Commission in this rule.[48]

Q. DID FERC PROPOSE A MECHANISM BY WHICH THE INCUMBENT UTILITY WOULD RECOVER INVESTMENTS MADE UNDER THE TRADITIONAL REGULATORY COMPACT?

A. Yes it did. Any customer eligible under the final rules to terminate its status as a customer of the regulated pipeline and choose from among competing providers could do so. However, in return for access to the competitive market, FERC required the departing customer to continue to contribute to the costs of past investments, irrespective of from whom the customer ultimately chose to take service:

> [A customer]...may remain a sales customer of the pipeline; otherwise, it may take an assignment of the pipeline's existing contracts [and] pay an exit fee/reservation fee surcharge[49]...Parties may also negotiate for the payment of an exit fee, in lieu of, or in combination with, a [transportation] fee surcharge. The exit fee could be a cash payment made by a sales customer that reduces or terminates its sales obligation during the restructuring period.[50]

Moreover, FERC sought to design a cost recovery mechanism which minimized cost-shifting among customer groups:

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[47] FERC Order No. 636, April 16, 1992 LEXIS 57FR13267 at *95.

[48] FERC Order No. 636, April 16, 1992 LEXIS 57FR13267 at *100.

[49] FERC Order No. 636, April 16, 1992 LEXIS 57FR13267 at *96.

[50] FERC Order No. 636, April 16, 1992 LEXIS 57FR13267 at *97.

> A fixed surcharge on...transportation...rates is selected...because it passes through the pipeline's costs of adjusting its gas supply inventory to the customers whose choices give rise to the costs, and the customers that will benefit from the unbundling and restructuring required by this rule.[51]

Q. DID FERC'S FINAL RULES ALLOWING RECOVERY OF PAST SUPPLY INVESTMENT WITHSTAND JUDICIAL SCRUTINY?

A. Yes they did. Importantly, the US Court of Appeals upheld FERC's stranded cost recovery policies understanding that assigning the surcharge to transportation services would not completely eliminate cost-shifting or insulate from the recovery of past costs those whom the contracts were not intended to serve. Equally important, the court did not conclude that complete insulation was possible or necessary, determining instead that equity concerns tied to the regulatory compact, and the fact that all consumers stood to benefit from the introduction of competition, outweighed strict adherence to the principle of cost causality:

> ...allocating [these] costs to transportation customers who admittedly may not have directly caused them is acceptable because, in the Commission's judgment, the extraordinary nature of this problem requires the aid of the entire industry to solve it; there are no other alternatives...all segments of the industry - including those who may not have caused the [the contract] problems - will nonetheless ultimately benefit from their resolution and the concomitant move toward an open access regime; consequently, all segments can rightly be assessed a portion of [the] costs.[52]

Q. DID FERC PROVIDE FOR ANY OTHER REGULATORY REFORMS IN ITS FINAL ORDER?

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[51] FERC Order No. 636, April 16, 1992 LEXIS 57FR13267 at *100.

[52] (Court, V (B)(3)(a))

A. Yes, it did. As important as its decision to permit 100 percent cost recovery was FERC's decision to relieve the incumbent of its supply obligations under the new structure. By "...permitting pipelines to abandon firm sales obligations where customers elect to reduce or terminate purchase...," FERC correctly recognized that the incumbent would face a severe competitive disadvantage if it faced service obligations its competitors did not.

Q. ARE YOU SUGGESTING THAT THIS COMMISSION SHOULD ADOPT THE ACTIONS TAKEN BY FERC, OR OTHER STATE COMMISSIONS, IN CONJUNCTION WITH THE TRANSITION TO COMPETITION IN THE NATURAL GAS AND ELECTRIC INDUSTRIES?

A. No, absolutely not. The explanation provided above should by no means be misconstrued to imply that this Commission, or decision makers generally, ought to blindly apply approaches used in other industries to the transition in the telecommunications industry. Indeed, I have consistently encouraged decision makers to resist strongly attempts to apply a "one-size-fits-all" approach to any policy matter. But neither should we ignore issues and experiences common among the industries. These common features can do much to inform the critical decisions that policy makers must make to fulfill the promises of the Telecommunications Act and Utah's Reform Act.

It is true that the economics and technology underlying the telecommunications industry differ from other, previously regulated industries and the telecommunications industry's historic roots are unique to itself. At the same time, this industry is not the first to undergo the transition from monopoly franchise and extensive regulation to one based on market forces and competition. In key respects, the economic and public policy issues confronting decision makers in the telecommunications industry are similar to those confronted during the transition to competition in the US natural gas and electric industries. Most significant is the regulatory compact, which represents the common thread running through each.

At the state and federal level, decision makers in the electric and natural gas industries recognized that 1) the incumbent must continue to face a reasonable opportunity to recover past investments made in compliance with the traditional regulatory obligations; 2) all competitors must face the same obligations–that is, obligations asymmetrically applied means inefficient competition; and, 3) cost recovery and reforms must occur ***simultaneous*** with the shift to competition. These are the principles U S WEST is advocating in this proceeding. They offer the Commission an economically rational and equitable policy route by which to navigate Utah's transition to competition in the telecommunications industry .

2. Depreciation Reform

Q. ARE THE DEPRECIATION AND COST RECOVERY MECHANISMS YOU ADVOCATE IN THIS PROCEEDING CONSISTENT WITH ACTIONS TAKEN IN DEREGULATING LONG DISTANCE MARKETS?

A. Yes, they are. During the transition from monopoly to a competitive environment in the long distance marketplace, AT&T argued for, and the FCC adopted, depreciation reform on the grounds that competition did not free the FCC from its obligations under the regulatory compact to give AT&T a reasonable opportunity to recover its embedded costs.

Q. PLEASE EXPLAIN IN MORE DETAIL HOW THE FCC ALLOWED AT&T TO RECOVER ITS EMBEDDED COSTS THROUGH REFORM OF ITS DEPRECIATION LIVES.

A. Simultaneous with the transition to increased competition in the market for interexchange services in the 1980s, the FCC implemented reforms to ensure AT&T recovered its embedded costs. The FCC did so noting that "competition in AT&T's interstate telecommunications markets is...increasing." It further noted that "the use of current depreciation methods may not be adequate to allow AT&T a reasonable opportunity for 100% capital recovery."[53]

Throughout the 1980s, AT&T consistently argued before the FCC that it should be allowed to change depreciation lives to reflect the effects of increased competition on asset lives, to amortize its depreciation reserve deficiency, and to recover these costs through rates. In 1985, the FCC authorized a 4-year amortization of the reserve deficiencies in all of AT&T's depreciable accounts within its interexchange divisions, totaling $700 million.[54] Following AT&T's announcement in 1988 that it would, for financial reporting purposes, write down $6.7 billion in analog circuit equipment, the FCC issued an interim order allowing AT&T to amortize $144 million in its analog circuit regulatory accounts.[55]

Despite these actions, AT&T continued to assert that competition required the FCC to enact additional reforms. In a February 1989 petition to the FCC, AT&T

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[53] FCC Decision 85-342, 101 FCC 2d 136 (July 1, 1985).

[54] FCC Decision 85-342, 101 FCC 2d 136 (July 1, 1985).

[55] FCC Decision 90-43, 5 FCC Rcd No. 3 (January 25, 1990).

claimed that the FCC's application of traditional rate of return regulation had, for years, resulted in artificially long depreciation lives applied to AT&T's interexchange services plant and equipment. AT&T argued in its petition for more frequent depreciation rate reviews and for the authority to apply, across all states, rates equal to the economic rates it used for financial reporting purposes. In response, the FCC agreed to establish biennial reviews, permitted AT&T to accelerate its depreciation lives, and allowed AT&T to apply those economic lives nationally. Taken together, the FCC's actions resulted in a $994 million increase in AT&T's annual depreciation expense effective retroactively to January 1, 1989.[56]

Q. DID AT&T RELY ON THE TRADITIONAL REGULATORY COMPACT TO SUPPORT ITS CONTENTION THAT THE FCC WAS OBLIGATED TO ENSURE AT&T'S RECOVERY OF PAST INVESTMENT COSTS?

A. Yes, it did. In its February 1989 petition, AT&T argued strongly that the Commission faced a clear regulatory and legal obligation to continue to afford AT&T's shareholders a fair opportunity to recover capital invested under the traditional, rate of return regulatory framework. AT&T asserted that regulators could rely on rate of return regulation and uneconomic depreciation rates to achieve public policy objectives only to the extent that they could also sustain the monopoly franchise and AT&T's reasonable opportunity to recover its investments. AT&T argued further that while the continuing erosion of its franchise required the FCC to reform regulation, it did not permit the FCC to

[56] FCC Decision 89-325 (November 22, 1989) granted AT&T's petition for biennial depreciation reviews and application of nationwide depreciation rates. FCC Decision 90-43, January 25, 1990, adopted AT&T's petition for accelerated depreciation lives and continued the Analog Circuit Account amortization.

abandon its obligations to AT&T's shareholders under the traditional regulatory compact. AT&T looked to the regulatory compact's basic tenets and legal precedent to support its requests:

> Under this fundamental regulatory compact, investors in public utility assets are entitled to full capital recovery through depreciation charges allowed to the utility - a principle long recognized by the Supreme Court and the Court of Appeals.[57]

> Under established law, the Commission is required to give AT&T the opportunity to recover the difference between its MR [regulatory] and FR [financial] depreciation reserve amounts.[58]

> Unless the Commission's currently prescribed depreciation rates are...changed, AT&T will be denied the opportunity–to which it is entitled by law–to recover its capital costs.[59]

> If the Commission failed to permit AT&T to recover capital costs in its service prices when it might have the market opportunity to do so...AT&T would be precluded from having a reasonable opportunity to recover those capital costs at all, and <u>unlawful confiscation would result</u>.[60]

In support of AT&T's petition, Dr. Ronald E. White reinforced AT&T's claims, stating:

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[57] Petition of AT&T before the FCC, in the Matter of the Modification of the Commission's Depreciation Prescription Practices as Applied to AT&T, February 15, 1989, p. 29.

[58] Petition of AT&T before the FCC, in the Matter of the Modification of the Commission's Depreciation Prescription Practices as Applied to AT&T, February 15, 1989, p. 28.

[59] Petition of AT&T before the FCC, in the Matter of the Modification of the Commission's Depreciation Prescription Practices as Applied to AT&T, February 15, 1989, p. 4-5.

[60] Petition of AT&T before the FCC, in the Matter of the Modification of the Commission's Depreciation Prescription Practices as Applied to AT&T, February 15, 1989, p. 9.

> The period of transition between partial regulation and total deregulation must be used to eliminate reserve imbalances created by the changing economic and technological forces which have spurred competition. Failure to eliminate these imbalances will systematically deny regulated carriers subject to competition an opportunity to recover its capital invested during previous eras when markets were closed to competition.[61]

Q. DID THE REGULATORY COMPACT FIGURE INTO THE FCC'S REASONING DURING THE COURSE OF REFORMING ITS REGULATION OF AT&T'S DEPRECIATION POLICIES?

A. Yes, in its decisions allowing for reserve deficiency amortization and accelerated depreciation the FCC repeatedly acknowledged its regulatory obligations.[62]The FCC stated, for example, that its reforms would "increase the speed of AT&T's capital recovery" in fulfillment of "our regulatory responsibilities."[63] In doing so, the FCC reaffirmed its commitment to using its depreciation practices to ensure full capital recovery for AT&T's investors:

> For communications carriers, the calculation of depreciation rates is of utmost importance because depreciation expense is a major cost of providing telecommunications service. Thus, we have placed great importance on ensuring that carriers subject to our jurisdiction recover their capital in a timely manner.[64]

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[61] Petition of AT&T before the FCC, in the Matter of the Modification of the Commission's Depreciation Prescription Practices as Applied to AT&T, February 15, 1989, Attachment B, Statement of Ronald E. White, Ph.D, Foster Associates Inc. in Support of AT&T Petition for Modification of Depreciation Rate-Setting Practices, p. 9.

[62] Indeed, in its petition, AT&T points to statements made by the FCC as far back as 1977 that AT&T's investors were "entitled to the opportunity" to recover their investment and that depreciation policy should be designed to ensure that investors "regain...the entire amount the investors paid to purchase" the assets. (FCC Decision 77-150, 64 FCC 2d 1, March 1, 1977, at 66-67. In further support of its position, AT&T also referred to a 1981 FCC decision in which the FCC states that the "depreciation process [must] provide full capital recovery." (FCC Decision 81-350, 87 FCC 2d 916, August 18, 1981, at 918.)

[63] FCC Decision 89-325, 4 FCC Rcd. 25, November 22, 1989, p. 8570.

[64] FCC Decision 89-325, 4 FCC Rcd. 25, November 22, 1989, p. 8567.

The FCC further acknowledged that depreciation practices could not remain static during a company's regulatory history, but must evolve to reflect changing circumstances. Thus, in order to ensure that AT&T faced a reasonable opportunity to recover capital expenses in a "timely manner," the FCC moved to adapt its depreciation policies to match the changing conditions facing AT&T:

> Our initial response to the industry's reserve imbalance was...[to] change our depreciation prescription procedures to reduce the possibility that our prescribed rates would be based on large errors in forecasting asset service lives...As a further step to assuring prompt capital recovery, we thereafter determined that an additional step might be necessary to bring about a more timely closure of the gap between the carriers' book reserves and theoretical reserves. We agreed to consider on a case-by-case basis the appropriateness of a carrier amortizing its reserve imbalance...rather than waiting for the remaining life procedures to reduce the imbalance.[65]

Q. DOES FAILURE TO ALLOW INCUMBENT LECS TO RECOVER THEIR DEPRECIATION RESERVE DEFICIENCIES AND APPLY ECONOMIC DEPRECIATION LIVES CONFLICTS WITH THE REGULATORY COMPACT, AND IS LIKELY TO HINDER COMPETITION AND CAUSE INCUMBENT LECS FINANCIAL HARM?

A. Yes. Regulatory depreciation policies designed to keep retail rates low, though well intentioned, simply are not compatible with a competitive regime. Decision makers could keep depreciation rates artificially low when the monopoly franchise kept revenues streams stable and predictable. However, as the monopoly franchise disappears, the regulatory tools available to manage cash flows will diminish precipitously. Thus, unless depreciation rates are allowed to migrate to economic levels, and unless U S WEST is permitted to recover the

[65] FCC Decision 89-325, 4 FCC Rcd. 25, November 22, 1989, p. 8567.

depreciation reserve deficiency created by decades of uneconomic depreciation rates and increased competition, U S WEST will face both a significant competitive disadvantage vis-à-vis new entrants and substantial and continued threats to its financial health.

Moreover, to fulfill its universal service, ready to serve and carrier of last resort obligations under the traditional regulatory framework, U S WEST made substantial investments in the ubiquitous telecommunications network through out its service territory. U S WEST made those investments–and met its responsibilities–with the understanding, and the expectation, that it would face a reasonable opportunity to recoup its investment and earn a fair return on that investment. In addition, as Baumol and Sidak explain, violating what is the regulatory compact's most fundamental tenet will inject considerably more risk into U S WEST's operations, thus increasing both U S WEST's cost of capital and the prices consumers ultimately pay for use of the network:

> Failure to allow recoupment of stranded costs will clearly violate this implicit regulatory compact. And aside from inequity, the failure to recoup could also deter capital investment...[I]nvestors may come away with the lesson to avoid investing in partially regulated...utilities[66]

Finally, the combined effect of higher capital costs and inability to recover past investments could greatly deter the additional investment necessary to maintain network reliability and accommodate interconnection and competition.

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[66] "Pay Up or Mark Down? A Point-Counterpoint on Stranded Investment," by William J. Baumol and J. Gregory Sidak, *Public Utilities Fortnightly*, May 15, 1995, p. 22.

It is ironic–though not altogether surprising–that AT&T, which fought for reform of depreciation policy and recovery of depreciation reserve deficiency at the federal level, now opposes U S WEST's request for similar treatment. Although AT&T received the support of the RBOCs during its many depreciation and price cap proceedings, it has refused to support RBOC claims for accelerated depreciation, embedded cost recovery and rate reform. In a recent interconnection arbitration proceeding with U S WEST before the Utah commission, AT&T witness Carlos Martins-Filho explicitly denied that U S WEST should be assured a reasonable opportunity to recovery its embedded costs as competition develops in local exchange services:

> [I]t is claimed that these [TSLRIC] prices will result in the ILEC being unable to recover its investment for a portion of its embedded costs (i.e., a portion of the ILEC's plant will be stranded)...One must be clear...if such arguments are used to justify cross-subsidies and transfers and continue them in the future by embedding them in...pricing, then local exchange competition will not succeed...The success of competition requires that regulators avoid using ILECs' historical accounting investment data to compute forward-looking TSLRICs...Regulatory policies that attempt to maintain incumbents; profit while promoting competition are fundamentally incompatible.[67]

This stands in stark contrast to AT&T's arguments during its own transition toward competition in interexchange markets. Then, AT&T argued that embedded cost recovery was essential for promoting efficient competition:

> A major goal of the Commission is to increase economic efficiency by promoting competition in the interexchange marketplace, fostering improvements and encouraging technological developments that benefit telecommunications users. In order to achieve this goal, it is essential that AT&T's [regulated] depreciation expenses

[67] Direct Testimony of Carlos Martins-Filho on Behalf of AT&T Communications, Before the Utah Public Service Commission, Docket No. UT-960309, July 25, 1996, page 23-24.

> reflect...marketplace realities. Otherwise, wrong signals are given to competitors, investors and regulators. Such erroneous signals can distort competition and hinder technological innovation.[68]

AT&T has also, despite its past arguments before the FCC, opposed recent U S WEST attempts to bring its rates closer to economic costs in preparation for competition. In 1989, AT&T argued before the FCC that "if the Commission prescribes depreciation expense for AT&T which understates economic costs as measured by the marketplace, prices will depart from economically sound cost-based levels."[69] In a recent rate rebalancing case in Colorado, AT&T argued *against* U S WEST's use of economic depreciation lives and requests for rebalanced rates. AT&T witness Jonathan Wolf, testifying before the Public Utilities Commission of Colorado, stated that U S WEST's rate rebalancing requests masked anti-competitive intentions and accused U S WEST of obstructing, not promoting, competition:

> It is clearly in U S WEST's business interest to be obstructionist in the wake of substantial regulatory reform. Protection of their monopoly interest is of paramount importance...Every time there is a potentially adverse change in the regulatory environment, U S WEST presents testimony...that the "sky is falling." Is the sky really falling? We think not.[70]

In addition, AT&T recently argued that the regulatory compact no longer existed between regulators and U S WEST, despite its vehement statements as to

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[68] Direct Testimony of Carlos Martins-Filho on Behalf of AT&T Communications, Before the Utah Public Service Commission, Docket No. UT-960309, July 25, 1996, p. 17.

[69] Petition of AT&T before the FCC, in the Matter of the Modification of the Commission's Depreciation Prescription Practices as Applied to AT&T, February 15, 1989, p. 18.

[70] Direct Testimony of Jonathan P. Wolf on Behalf of AT&T, Before the Public Utilities Commission of Colorado, Docket No. 96S-257T, September 26, 1996, page 7. See also testimony of AT&T witness Arleen Starr in same proceeding. Starr argued that U S WEST 's cost studies should be rejected, as they used economic depreciation lives not yet approved by the Commission.

regulators' obligations to itself in 1989. When AT&T wanted assurance of recovery of its embedded costs during deregulation of its markets, it argued that a "fundamental regulatory compact" entitled investors to "full capital recovery."[71] In a recent cost proceeding in Colorado, AT&T argues that "any regulatory compact of the past was overturned when the decision to allow entry was made...[and] ILEC appeals to be made whole...should be ignored."[72] AT&T clearly understood the substantial competitive disadvantage in which it would find itself absent reform, when it argued strenuously for depreciation rate reform and recovery of its capital reserve deficiency in 1989. AT&T obviously understands that U S WEST awaits a similar fate unless similar reforms and recovery mechanisms are enacted. Clearly, AT&T's current advocacy is directly at odds with the position taken before the FCC when AT&T itself faced the incompatibility of increased competition with outmoded depreciation policy. This Commission should therefore grant U S WEST's request with respect to depreciation policy reform and depreciation reserve deficiency recovery through a transitional prorated charge on tandem and end office switching, and reject AT&T's meandering and self-interested opinions on the topic.

[71] Petition of AT&T before the FCC, February 15, 1989, p. 29.

[72] Direct Testimony of William Lehr on Behalf of AT&T and MCIMetro, February 21, 1997, in Colorado PUC Docket No. 96S-331T, p. 29.